GINNIE MAES: FOLLOWING THE RATE TREND WHILE AVOIDING RISK

FUND FACTS

USAA GNMA TRUST (USGNX)

CATEGORY:
Mortgage-Backed Bond

PERFORMANCE: (thru 12/31/98)

Compound Annual Return (%)	Fund	Category
1 Year	8.2	6.5
3 Years	6.8	6.4
5 Years	7.3	6.3

RISK: (relative to category)
High

TOTAL ASSETS: (as of 1/1/99)
$460 million

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While much of the popular focus has been on stocks, including the stellar performance of the large-cap stocks, diversification requires that some attention be paid to other segments of the investment marketplace, such as bonds.

One segment of the bond market that has appeal to certain individuals is mortgage-backed pools, in which investors receive payments of interest and principal from the underlying mortgages. In general, these essentially intermediate-term issues offer a slightly higher level of income than other intermediates due to uncertainty concerning the timing of the payments.

One mortgage-backed bond fund that has done quite well over the long term is the USAA GNMA Trust, which invests primarily in mortgage-backed securities guaranteed by the Government National Mortgage Association (GNMA), a U.S. government agency; the issues (called Ginnie Maes) are thus fully guaranteed by the U.S. government. The USAA GNMA Trust has ranked among the top 25% for its category for all periods, including the last year, last three years, and last five years.

In early January, portfolio manager Kenneth Willmann discussed the management of the fund with Maria Crawford Scott.

What is the investment philosophy of the fund?

The objective of the fund—the official legal investment objective—is a high level of income without undue risk to principal. We buy only the full faith and credit of Uncle Sam—we don't buy anything that is not a direct U.S. Treasury guarantee or issue—so that is basically Ginnie Maes and U.S. Treasury bonds. There are a few odds and ends, some SBA loans and things like that fall in there. Fannie Mae and Freddie Mac are not. What we have from a credit standpoint is a very secure fund.

As a philosophy, as opposed to a legal requirement, we do not do any collateralized mortgage obligations (CMOs) of any kind.

So, that's the legal framework within which I must operate. Now I'll tell you where I do operate. My philosophy is based on the fact that since about 1981 we've had declining interest rates in this country. I mean they've been up and down, but their trend has definitely been down and that continues to be the case, though we are obviously much closer to the end of that than we were a couple of years ago. We are in a very, very long-term trend. The biggest problem that creates for a Ginnie Mae fund is prepayment risk, and that's what I try to avoid.

Could you explain prepayment risk?

As we all know, you can prepay a mortgage anytime you feel like for an individual, single-family home, and there is no penalty for doing that. As a result, when interest rates decline, people tend to pay off their mortgages and refinance to lower ones. Of course, there are lots of other reasons people prepay their mortgages that have nothing, or very little, to do with the level of interest rates, such as moving or taking out a loan. But it is a fact that if interest rates decline, prepayments increase because you add in the refinancings along with these other reasons for prepayments.

Now, with a mortgage fund you have scheduled pay-downs every month, as mortgage payments come in, so you do get some principal back at par every month, which then has to be reinvested. The fact that you get some principal back to reinvest every month tends to keep the fund from being as volatile as

a regular bond because you are constantly getting money back to reinvest at the current rate. So the standard mortgage securities are not as volatile as regular bonds.

But the prepayments are a return of principal above the amount you would have expected from the mortgage pool. And the risk of prepayment when rates are down is that you have to reinvest at the current lower rate. If in 1994 you had bought 9% mortgage securities at par and you still owned some and they were prepaid, you're having to take whatever principal that comes back from that and reinvest it at the current going rate, which is right now 6½% at par, so you're losing 2½% of income. The risk in prepayment is that your income goes down.

The prepayment risk was really apparent in 1993 before I started managing the fund, when there was the first big, huge crush of prepayments, and 9% and 10% mortgages were prepaid to investors and they were reinvesting at 7%, so people's principal got hurt—I mean the income went way down.

Ginnie Mae funds really got hurt in 1993. Taking that to heart, what I have done is to try to minimize prepayment risk, and I've done that in two ways. One way is to purchase low-coupon mortgage pools—ones that are trading below par, on the assumption that you don't refinance securities that are already at or below the going mortgage rate. If you have a 6½% mortgage right now, you don't refinance it.

The other thing I've done is to get into the commercial mortgage business. A lot of people don't realize this, but GNMA puts its guarantee on various kinds of commercial mortgages—basically they're FHA mortgages. They don't come in pools, they come in individual mortgages, typically from $3 million to as big as $50 million, although most are around $5 million to $15 million. We are talking about apartment houses and nursing homes, things that the FHA would insure. The reason I got into these issues is that they have an interesting structure—they typically carry a 10-year lock-out period, which means they cannot be prepaid for 10 years. As a lender, you get regular monthly scheduled pay-downs just like you would on a mortgage, but they can't be refinanced for 10 years—so you've gotten rid of your prepayment risk. In essence, you've got an intermediate-term bond that is non-callable, and that is part of the way they trade—investors assume they're going to be paid-off at the first chance, so in essence, they are priced as if they were a 10-year bond.

Do they tend to have lower coupons?

No, they actually tend to have higher coupons, which makes it even more interesting. So you actually get a little bit of income and you get prepayment protection.

Do they have higher coupons because they are commercial?

A couple of years ago, on a given day they would yield a little more than a single family mortgage—let's put it that way. Right now they yield about the same. What really happened is they were not widely known, it was kind of a niche in the market that had its own set of players, and, basically, I've tried to take advantage of that. It worked out real well, and we still have a fair number of those. Today, you get closer to the same level of income [as a non-commercial Ginnie Mae], but you get the prepayment protection. Also, they are a little less liquid. Now, they are still very, very liquid, but they are just not quite as liquid as regular Ginnie Maes.

What about the average maturity of the fund and interest rate risk (the risk caused by changes in interest rates, since bond prices drop when rates rise and vice versa)?

Remember, I focus only on Ginnie Mae securities here, so I'll refer to what is possible within that universe. And what is possible is, on a very liquid basis, 30-year and 15-year mortgage pools. The commercial mortgages are 35 to 40 years of maturity, but they don't trade that way because you trade them to the lock-out date.

I own only 30-year mortgages, but you have to remember that in these mortgage pools you get principal back every month. And that means that the average length of time outstanding is much shorter than the final maturity.

A typical 30-year Ginnie Mae would be roughly comparable to what kind of maturity bond?

Eight or 10 years. It is an intermediate fund. Mortgage securities almost by definition are intermediate.

How do you like to position the fund within the intermediate-term range?

I'm on the longer end of that.

Why?

These issues all trade on their average life, because there is an expectation of pay-down, either scheduled or prepaid. In fact, the average life is based typically on an estimate of prepayments as well as the regular pay-downs. So, if you buy securities that have prepayment protection or are structured in a way that gives you a pretty good sense of what those prepayments are going to do, it allows you to have a slightly longer average maturity. I'm not married to that, but for the moment it seems like the right place to be. It is not a day-to-day bet, it is a trend I am following.

Now, this is very mushy, not very precise stuff. A lot of regular bond analysis is very statistical. You know with some certainty when you're going to get which cash flow and how much it is going to be to the penny. That is absolutely not true with mortgage securities. You're never sure when you are going to get it all back. You have to estimate.

So your approach to interest rates and the maturity of

the fund is based on your opinion as to how the prepayments are going to occur?

That's correct—the expectation for prepayments over the next several months.

What is your outlook for interest rates based on?

I don't make bets on interest rates. I will tend to find a trend and ride it for as long as it will go, and I think I'm still doing that with this one. I don't try to guess what the trend is; I try to identify a trend that is there. I try to look and think about how long the trend that we're currently in is, what is causing it, and how long that is likely to stay in existence.

The portfolio has relatively low turnover. What kinds of things would prompt you to sell a security in the fund?

I haven't sold very many. First, the fund has been getting money in, so there hasn't been a need to. Second, I'm dealing with tilting a portfolio more than making radical changes. To the degree that I have positive cash flow, I'm using the new money to tilt it to buy the things that I think are going to do better.

I guess what would cause me to sell something is a major, at least perceived by me, shift in interest rates that might cause me to sell certain things one way or the other.

Also, these issues do pay down pretty fast, and I would sell a specific security if it got to be a very small position. At some point, you have to ask whether it is worth keeping this little bitty piece because there is an expense involved to a fund for every individual line item security that you have.

For an individual going into the fund, what are the advantages of a Ginnie Mae fund compared to an intermediate-term bond fund?

The creditworthiness is typically higher—it simply has no credit risk.

But the income tends to be higher?

Yes, you are definitely compensated for the lack of certainty that you have from a structural standpoint, not from a credit standpoint. In other words, there is no chance that you won't get your interest and principal back, but you won't know exactly when. And for that uncertainty, you get compensated a fair amount—actually quite a bit. The [Ginnie Mae] new construction loans and new project loans are in the vicinity of 1¾% higher than a 10-year Treasury. A project loan is what you call a commercial mortgage. A construction loan is used to build a commercial mortgage, and when the project is completed and accepted by FHA it converts into a project loan. Construction loans yield more than project loans do.

Ginnie Maes in general yield like a BAA corporate, or certainly a weak A, even though the creditworthiness is much better than that bond. So what you have is a bond that yields like a long-term security—I mean the income is like a long-term security, but the volatility of the bond is like an intermediate-term security, and the creditworthiness is like a Treasury fund.

What about the risk an individual would face? The condition under which a Ginnie Mae fund would not do well would be rapidly falling interest rates?

Yes, though mine is set up to do pretty well under those circumstances, but on average that is right. Ginnie Mae funds in a rapidly falling interest rate environment don't do very well because prepayments pick up so much and you're having to reinvest all the time in much lower coupons. Your income goes down fairly rapidly.

And in a moderately declining interest rate environment, how would they fare as compared to just a straight bond fund?

Well, if the decline is pretty slow, it should be similar. It is going to do best in an interest rate environment where interest rates don't change very much, up or down. In a slowly declining interest rate environment, it will be like a regular bond fund—it will be positive, maybe not quite as positive as a regular bond fund. In a slightly increasing interest rate environment, it should do much better than a regular bond fund.

If interest rates now are at an all-time low, what is your outlook on the risk of interest rates declining further? In other words, what's your outlook for interest rates?

Let me back up by addressing your statement that they're at an all-time low. In the 1940s, we had 10-year Treasuries with fractional interest rate coupons. If you go back and examine interest rates since the beginning of the century, we're basically at the average. The last 15 to 20 years was extremely high compared to history; you would have to go back to the Civil War to discover interest rates that are even close to as high as they were in the 1980s. So the odd time period in interest rates over the last century has been the last 15 years or so.

So, given that and my outlook concerning all the deflationary news that is going on around the world and all the economic problems that are going on around the world, I believe there is some chance we could have interest rates go somewhat lower. There is certainly no pressure for them to rise. Stable to lower would be my outlook because I really can't see any reason for them to rise, which makes me very nervous.

And why is that?

Because anytime anything is really obvious, I'm missing something. If you don't think that, you are a bad portfolio manager.✦